NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on October 14, 2010 that relates to the Board's release on solicitation of comment on rulemaking concepts relating to the Sarbanes-Oxley Act's provision on "Failure to Supervise". The other topics discussed during the October 14, 2010 meeting are not included in this transcript excerpt.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

SAG MEETING

National Association of Home Builders

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On the next topic, we're discussing rulemaking on failure to supervise, and Bella Rivshin, our Associate Chief Auditor, and Michael Stevenson, Deputy General Council, will lead that discussion. But to kick off the discussion, I'm going to turn the microphone over to Steve Harris to begin. Thanks, Steve.

MR. HARRIS: Well, thank you, Marty. And I want to preemptively thank everybody for their very active discussion on this topic to come, as well. So, we're looking forward to your active engagement on it.

This is not a new topic. Members of the SAG first discussed the auditor's responsibility to supervise on February 27, 2008. And a number of you, I know, were present at that meeting. During today's discussion we are seeking your views specifically on the Board's August 5th, 2010 release relating to the application, the Failure to Supervise provision of the Sarbanes-Oxley Act.

The release addresses two critically important objectives. The first is to remind auditors that the Board has the authority and will use it to take disciplinary action against a registered public accounting firm or a supervisory personnel, where appropriate, for a failure to supervise. The second objective is to solicit on -- to solicit comment on specific concepts for developing a rulemaking proposal that could lead to a firm's documenting the supervision responsibilities relating to each audit, from the first-line supervisor for each part of an audit, all the way to the responsibilities of the managing partner of the firm. This objective, in particular, is what we would like to discuss today.

Since coming to the Board in June, 2008, I have been struck by the volume -- and this is meant to be a deliberately broad statement -- of supervisory concerns brought to our attention by our Inspection Division. For example, in the Board's December, 2008 report on large firm inspections, the Board identified inadequate supervision and review as an important factor that allowed audit deficiencies to occur. In addition to questions about the supervision review activities of engagement managers and partners, the Board identified supervision-related concerns in several other areas, including partner evaluation in compensation processes, concurring review policies and procedures, internal inspection programs, and the evaluation, supervision, and control of work performed by foreign affiliates.

As the release states, the Board is therefore considering proposing rules requiring firms to make and document clear assignments of relevant supervision responsibilities throughout the firm. The Board is considering whether such rules would serve to further the public interest and protect investors by increasing clarity about who within the firm is accountable for various supervisory responsibilities that bear on the quality of the firm's audits.

The comment period on the Board's release will remain open until November 3rd, and we encourage you to submit written comments on the potential rulemaking concepts. We are especially interested in hearing how investors, audit committee members, and others who rely upon audited financial statements view the importance of clearly defined and documented supervisory responsibility at accounting firms.

And at this time, I will turn the floor over to Michael Stevenson and Bella Rivshin, who will provide additional information regarding the Board's application to failure to supervise provision, and moderate today's discussion on the potential rulemaking concepts.

MR. STEVENSON: Thank you, Steve.

As Steve noted -- Steve described the two prongs of the August 5th release. I'm going to provide brief background on the first point, the first piece of it, relating to the scope or potential application of Section 105(c)(6) of the Act, as described by the Board in the release.

And Bella will discuss the second point, the rulemaking concept portion of the release, with respect to which the Board is seeking public comment and seeking your input today.

Under Section 105(c)(6) of the Act, if an associated person of a registered public accounting firm violates any provision of law, rules, or standards referenced there in the Act, the Board may, in addition to imposing sanctions on the person who commits the violation, impose sanctions on other individuals, or the firm, if the Board finds that there was a failure reasonably to supervise that associated person.

Specifically, Section 105(c)(6) provides that the Board may impose sanctions on a registered firm or a, quote, "supervisory person," closed quote, of the firm if an associated person of the firm commits certain violations -- which I'll refer to a predicate violations -- and the firm has failed reasonably to supervise that person, either as required by the rules of the Board relating to auditing or quality control standards or otherwise, with a view to preventing such violations.

You can see that there are two distinct bases there: failure reasonably to supervise as required by rules or standards -- what I'll refer to as the rules clause of the section -- and a failure otherwise to reasonably supervise -- what I'll call the "or otherwise" clause.

In isolation, the rules clause of Section 105(c)(6) would be essentially redundant of authority provided to the Board elsewhere in the Act. That is, to the extent the Board adopts rules or standards related to supervision, the sanctioning authority provided through the rules clause of Section 105(c)(6) overlaps with the Board's separate broad authority to impose sanctions for violations of rules and standards as provided in a different section of the Act.

On the other hand, the range of conduct that the Board might address through the "or otherwise" clause, encompasses conduct not covered by specific supervision rules or standards. For conduct in this category, the Board's authority to impose sanctions is found only in Section 105(c)(6), and would involve case-by-case determinations concerning the reasonableness of supervision and particular circumstances, without regard to whether any specific supervision rules or standards are implicated.

This is probably a good point to mention, that the Senate report on the Act describes Section 105(c)(6) as intended to provide for liability on terms that are similar to those that apply to broker-dealers under the Exchange Act. Those Exchange Act provisions do not limit their application to circumstances involving violations of specific supervision rules. And in that sense, the "or otherwise" clause in Section 105(c)(6) helps to fulfill the intent described in the Senate report.

The release also discusses the scope of persons who might be subject to sanctions under Section 105(c)(6). The Act provides that the Board may impose sanctions on a firm or upon a supervisory person of a firm. The question arises how, if at all, that limits the universe of associated persons whom the Board may sanction for failure to supervise.

To the extent that Board auditing standards prescribe supervision obligations for any specified category of individuals, they're essentially limited to obligations imposed on members of the audit engagement team. The reach of Section 105(c)(6) though, is not limited in that way, nor does anything in Section 105(c)(6) indicate that the term "supervisory person" limits that section's reach to those with direct and immediate supervisory responsibility for the associated person who commits a violation. Any associated person in the firm, including the most senior personnel of very large firms, could be a supervisory person for Section 105(c)(6) purposes, depending upon the nature of his or her responsibility, ability, or authority in relation to the conduct of the associated person who commits a predicate violation.

That said, it does not follow that each person with such responsibility, ability, or authority, in relation to a particular violation, could be sanctioned merely because the predicate violation occurred. The release describes the Board's view that Section 105(c)(6) sanctions would be appropriate only where, in relation to the predicate violation, there has been a failure to exercise such responsibility, ability, or authority reasonably.

Another significant scope question relates to identifying areas of responsibility that can be understood as involving responsibility to supervise, in the sense that makes the conduct reachable through Section 105(c)(6). Some supervision responsibilities are rooted in certain Board auditing standards. For example, AU Section 311 and its Board-adopted successor on supervision, AS Number 10, imposed certain obligations on the engagement partner to supervise the work performed on a particular audit.

Additional supervision responsibilities are rooted in the Board's quality control standards. The introduction to those standards notes that they relate to quality control procedures to ensure that services are, quote, "competently delivered and adequately supervised." Closed quote. QC standards broadly define a system of quality control as a process to provide the firm with reasonably assurance that its personnel comply with applicable professional standards and the firm's standards of quality. QC standards include a section on monitoring a firm's audit practice and include a section on a firm's responsibilities related to staffing audits, particularly the firm's responsibilities concerning the competencies of the practitioner in charge of an audit.

Associated persons who have responsibilities related to implementation of components of those categories, whether broadly or with respect to only a portion of the firm's audit practice, have responsibilities that, depending on the facts and circumstances, could be understood as supervision responsibilities in relation to an individual associated person.

Whether the connection between particular unreasonable supervisory conduct and a particular predicate violation is sufficient to warrant sanctions under Section 105(c)(6), will depend on the specific facts and circumstances. But as a general matter, as the Board described in the release, individuals' responsibilities for implementing a firm's QC policies and procedures are responsibilities that relate to supervision, and given a sufficient connection to a predicate violation, unreasonably carrying out those responsibilities could result in sanctions for failure to supervise.

The release also recognizes that Section 105(c)(6) does not create any form of strict failure to supervise liability for the firm or supervisory personnel just because an associated person commits a violation. Section 105(c)(6) provides the possibility of an affirmative defense that could preclude the Board from imposing sanctions against the supervisory person for failure to supervise. That section provides that no supervisory person can be found to have failed reasonably to supervise if the individual reasonably discharged the supervisory duties placed on him or her by the firm's procedures, and the individual had no reasonable cause to believe the firm's procedures were not being complied with, and the firm's procedures comply with applicable Board rules and would reasonably be expected to prevent and detect the violation.

That's a short overview of the -- part one of the August 5th release. And before I turn things over to Bella, I just wanted to highlight that -- as explained in the release and as reiterated by Steve, the Board has not, in the release, sought comment on the points I've been describing, rather the release expresses the view that -- I mean, debate about those points is more appropriately suited to take place in the context of the Board's application of them in concrete situations.

The release does, however, seek comment on conceptual approaches to rules to achieve a specific end, increasing clarity about who, within a firm, is accountable for various responsibilities that bear on the quality of audits. And for more on that, I'll now turn it over to Bella.

MS. RIVSHIN: Thank you, Michael.

Now I'd like to discuss the solicitation of comments on the rule-making concepts.

The PCOB staff, through inspections and

enforcement, at times has observed that the quality of supervision within a firm was affected by the lack of clarity regarding the allocation of various supervisory responsibilities at different levels within the firm's practice. The staff believe that the rules requiring the firm to make and document clear assignments of responsibility for implementing the necessary quality control policies and procedures could help avoid potential confusion within a firm about where the significant responsibility rests, the confusion that could potentially lead to gaps in supervision with consequent violations of the professional standards.

In addition, the staff believe rules could facilitate the PCOAB's assessment through the inspection process of a firm's supervisory practices. The potential rules could also facilitate identifying -- after a predicate violation has occurred -- the persons with relevant supervision responsibilities.

The types of rules the staff is considering would not create new supervision responsibilities, but would only address how clearly the firms assign responsibilities that are clearly already required to be part of the audit -- any audit practice. The potential rulemaking would be in addition to the Board's current quality control standards, QC20, 30, and 40.

The staff has preliminarily considered how such a rule might be crafted. The concept release outlines two potential approaches, a general and a more detailed approach. One possibility is to formulate a rule that only in the general terms requires assignment of responsibility and documentation of that assignment. Under this approach, a rule could build on the existing requirement that responsibility for the design and maintenance of the quality control policy and the procedures be assigned to appropriate individuals, and could require firms to document all such specific assignments, sufficient to cover the full range of the firm's obligation under the quality control standards, and to assign to other associated persons any appropriate higher-level supervisory responsibilities over those persons. In other words, if a firm complied with the rule, it could be possible to identify, with respect to a particular violation in an audit, any individuals who had responsibility for any aspects of the quality control system that failed, and to identify other individuals with supervisory responsibility. For those individuals, performance relating to the quality control system.

Another approach could involve a more detailed formulation. Under this approach, a rule could identify and define various specific areas of supervisory responsibility, and could require a firm to assign responsibility in each area to specifically identified individuals. The areas of supervisory responsibility identified in a more detailed approach could be derived from the Board's quality control standards. The potential benefit of a more detailed approach would not be to encompass more or different areas of supervisory responsibility than the general approach, but would just be to make more concrete the scope of the rules requirement so to reduce a risk posed by the general approach, that a firm might think that it has covered the relevant range of responsibilities, only to have the Board identify a gap in the firm's assignments.

The staff believes that the firm could have some flexibility in the aspects of how the approaches comply -- how it approaches compliance and with the potential rule under either potential approach.

Now the previous discussion on the FASB and the ISB accounting standards was very lively. And I hope you saved some of that energy and thoughts for this topic, because we would really like to hear some of your thoughts. And to start off the discussion, I'd like -- the staff is interested in obtaining feedback on whether such potentials rule -- rules would serve to further the public interest and protect investors by increasing the clarity about who within the firm is accountable for the various responsibilities that bear on the quality of the firm's audits.

Also, the staff is interested in hearing from investors, Audit Committees, and others, who rely on the audited financial statements, view the importance of the clearly defined documented supervisory responsibilities in the accounting firms.

And now I'll turn it over to start the discussion. Barbara Roper?

MS. ROPER: What the heck, since nobody is jumping in, I'll start.

I'm a strong supporter of having clear suitability standards in this area. I think it benefits everybody. My guess is, not knowing, you know, everything about how this works in the audit firm context, my guess is that there's some areas where supervisory responsibility is already clearly defined and clearly understood, and other areas, particularly within broader networks of firms, you know, the larger organization where there is less clarity.

And so, I do think there's a benefit to having a rule that requires a clear documentation, definition and documentation, of the entire, you know, chain of command of responsibility, and I think it needs to track up through the entire organization.

I think some of the benefits, you know, I think it focuses the mind of the individual who has that responsibility. If it's absolutely clear that they are the one holding the bag at the end of the day.

I think it gives the Board something to

inspect against, in terms of whether people are adequately performing their supervisory obligations. And in worst-case scenario, I think it, you know, can be the basis of enforcement actions, all of which, I think, have the potential to drive audit quality.

I don't have a strong opinion about the benefits of a more general versus detailed approach. My guess is there's some middle ground there that, you know, maybe defines general areas that have to be covered by this, but it doesn't need necessarily to be too prescriptive. The more prescriptive it is, the less scalable it is. The more prescriptive it is, the more tendency there is to think it defines the scope of the requirements, so, you know, less ability to adjust and adapt it to different firm models.

And, I think the Board has an effective mechanism, if it will use it, to require adjustments if it sees problems, which is, you know, the ability to require remediation based on inspections, creates that interplay between the firms and the boards that can drive this, you know, if there are inadequacies in the approach, can drive it in the desired direction.

You know, obviously that -- particularly in the early days, that should be not in a, sort of, gotcha approach, but in a, you know, look -- good first effort, let's -- we think there needs to be something more robust in this area or what-not, let's drive that conduct, and then, you know, use that as the basis for strengthening the requirements.

MS. RIVSHIN: Thank you, Barbara.

Arch?

MR. ARCHAMBAULT: Well, from my standpoint, I don't think you can over -- overstate the importance of supervisory responsibilities. And when I think about the years I've been dealing with our quality control system, some of the things you've indicated in here, it strikes me -- it really fits best into all your efforts that are going on with the QC standards, and to imbed it in those standards.

As Barbara indicated, I think if you try and get too prescriptive with this, it doesn't fit the wide range of firms that are going to have to be trying to implement it. You know, we have -- we certainly -- our people need, and so in our documented quality control, we lay out who has what responsibilities and in what areas. And, we're always looking at that from a standpoint of, how do we improve it, do we need to change it as things might change, and it's engagement level, it's client acceptance, it covers all of the different areas of the quality control system, and so that's why I just thought it would fit best in that effort, rather than something separate.

MR. BAUMANN: Just a follow-up, Arch. If I understood what you were saying, it sounded like, in your firm, you believe you follow sort of the general approach already, but for each area of responsibility that would be described in the QC standards, there is somebody, a person, who's identified with that responsibility? Is that what I heard you say?

MR. ARCHAMBAULT: Yeah, I wouldn't say by name because obviously people change over time, but positions, yes, in terms -- client acceptance is a good example. I mean, we have, depending of the nature of the client and certain vectors that we take into consideration, our levels of client acceptance, who has to be involved with the approval of a new client, it goes up the chain so to speak. And so, the positions are described as to how that is to take place.

MR. BAUMANN: Thanks.

MS. RIVSHIN: Arch?

Mary Hartman Morris?

MS. MORRIS: Thank you, Bella.

I just wanted to add to that. I agree with both Barbara and Arch on the requirements and I agree, it probably shouldn't be too prescriptive. I think it should be up to the audit firms.

But I think that one point I wanted to make sure that was pointed out. The ACAP recommendation, and it really does tie into some of the key indicators of audit quality, so I think this is just one more step towards doing that, so the firms, you know, they would document necessarily, you know, who would be responsible for certain assignments. But it would be maybe eventually tied to some of their key performance indicators of quality and the training and individuals that are involved in the actual reviews.

Thank you.

MS. RIVSHIN: Thank you, Mary.

Wayne Kolins?

MR. KOLINS: Yeah, I guess this is less contentious than the earlier discussion. I also agree with the general nature of how the guidance should be couched and it should be incorporated in the quality control standards. I think one thing is essential, is that there needs to be some kind of a clear delineation or a clear understanding of what constitutes supervisory personnel versus management personnel. I think it would be certainly something that the firms, with their various structures, would need to be able to know who fits within this particular part of the standard.

MS. RIVSHIN: Wayne, could you elaborate a little bit in terms of the supervisory personnel versus the management personnel? Are we talking about, kind of, the management of the firm and how those individuals --

MR. KOLINS: Yes.

MS. RIVSHIN: -- may never go to a supervisory level if you drilled down all the way down to the engagement partner?

MR. KOLINS: Yeah, I guess you're looking at what is their role in the firm and, you know, what aspect of their role might touch on the conduct of an audit and how they might affect the conduct of an audit, and how indirect does it have to get before they ultimately do. Because, you have people whose primary responsibilities are operational in nature, but within those operations there may be evaluation of personnel and it's -- sometimes it's hard to make a clear distinction between operations responsibilities and supervision responsibilities. And I think that has to be thought out some more before the guidance is promulgated.

MS. RIVSHIN: Thank you.

Steve Rafferty?

MR. RAFFERTY: Thank you. I had, honestly, a little trouble understanding the issue here, because if you just say failure to supervise, that's a fairly broad category of issues. It would be helpful to me to know more specifics about what the observations were from the inspections. What were the actual findings and the problems in the audit? Were they failure to review the work or something else?

And I would tend to question, then, whether -- I have a hard time believing, in most cases, that there's a really a lack of clarity, as opposed to a failure to execute. And, if it's a -- if it's a failure for people to do their jobs, which they ought to understand to begin with, then I would tend to agree with, perhaps where Arch was going, which was, this is really part of the quality control system and are there adequate hooks and tools and checks and balances in the quality control system to ensure that people do what they already know that they're required to do.

MS. RIVSHIN: Thank you, Steve.

Jim Cox?

MR. COX: The name John Goodfriend is famous in history for two reasons. One, he was the character in Tom Wolfe's novel, "The Lion," and thinking about -- the other one is that he was CEO of Solomon Brothers during the bond squeeze, by a person who later had a prime role, poster-child role in long-term capital. The reason I bring that up, is that as you draft this rule and you think about specificity versus nonspecificity and going either way and what you mean by supervisors, the leading authority in the securities law is the John Goodfriend decision, which was an SEC decision that sets forth its thinking about what makes one a supervisor. And it went through a whole cast of characters, which includes, by the way, the General Counsel of Solomon Brothers, and the SEC goes to great lengths to say that you're not a supervisor merely because the compliance office is run out of the general counsel's office, but because of the level of involvement with the General Counsel at Solomon Brothers, in the conversations about what to do about this character that was manipulating the Treasury bond market, a bidding process.

And, so I think that should be instructive to you, just going forward, as to at least what one regulator thinks the meaning of supervision means and what qualifies one as a supervisor.

MS. RIVSHIN: Thank you, Jim.

Lynn Turner?

MR. TURNER: I think you have to think in broad terms when you talk about supervision. The tone at the top takes you right to the very top, and we've heard people say how tone at the top is so important at companies, and it's no different for the accounting firms. And we've seen a number of cases, Xerox, Parmalat, Enron, where people right up to the very senior, most senior level in those firms were involved in critical and key decisions.

So, I don't believe a narrow definition of a supervisor is functional or will work. It will isolate the very people at the top who are so key to making sure that people have got the right mindset, from any responsibility, and I don't think that's a direction you want to go in, as well.

I would also say, though, probably much more effective than any rulemaking in this area which may be necessary -- I don't set that aside, though -- is a couple really good enforcement actions. If you found problems with people failing to supervise, then let's see the actions. I understand you've got this problem with these things staying private and people litigating. But let's -- if you've got a problem, you think it's a serious problem, let's see some of these enforcement actions and bring actions against a couple of these people, because I think that will do more to cause people in the field to actually start doing their job and supervising, to Steve's point, than will all the regulations you can possibly write.

If people know they're going to be held accountable for supervising, I think that will be great, but we've had rules for a long time that have said, you know, you're supposed to supervise and stay on top of these people. I can't imagine not a partner that doesn't understand that today. And so, if there's a breakdown down at the partner level, that person is the one ultimately accountable, and there's nothing like a good old couple of good fashioned enforcement actions, whacking those people really good, to wake everyone up and improve performance.

MS. RIVSHIN: Thank you, Lynn.

Barbara Roper?

MS. ROPER: Yeah, I agree very much with what Lynn just said about the need for enforcement actions. Yesterday I mentioned the large firm report that Levitt did during the early 1990s, looking at the nine largest broker-dealer firms. And the base -- and the issue there, again, was that there had been reports that the major broker-dealer firms were hiring individual registered reps with long records of customer abuses, and that those individuals were able to stay in the firm and continue to pile up additional customer abuses within firms that were supposed to have good strong procedures in place to prevent that sort of thing.

And, what Chairman Levitt did with that report was to basically say, one of the responses that we're making to this is going to be to put a much greater emphasis on failure to supervise. In other words, we're going to recognize this is not just an issue of bad apples, these are firms that are tolerating this conduct and we're going to hold people accountable up the chain for the decisions that allow that to happen, and that that is going to inform the way we approach enforcement in this area.

He announced it, everybody is on notice, and then, you know, you proceed with that approach. And I think that's -- that's key.

I also think this is, you know, not to beat a dead horse, increasingly important as we move into an area where we're dealing with more judgments. You know, the type of issues we've talked about, you know, related to the need to get more documentation, the need to be looking beyond just collaborating -- information that collaborates management decision, you know, the need to have adequate procedures in place to gather outside information that informs the audit -- those are issues that, for which I can see, the firm, you know, the culture that the firm sets, the expectations that they set, the guidance that they provide is going to drive partner conduct. And holding people accountable up the chain for the way they guide partner conduct, I think, will be helpful if we're going to have a chance of having, you know, the kind of audits that really hold the line and enforce the standards within a vaguer, less enforceable rule construct.

MR. BAUMANN: Thanks, Barbara.

I just wanted to follow-up on one thing, and Lynn had said something which I just wanted to again, Wayne, go back to the comment you made, just so I understand the point again, because it wasn't clear to me, yet -- making a distinction between management and supervisory personnel. And I think Lynn had talked about going right to the top of the organization, the person who sets the tone at the top. I guess that could be management, the CEO of the firm and his responsibility could be P&L, just for instance, you know, he's in charge of the profitability of the firm. But that still could have a supervisory aspect with respect to the partners who lead the practice in auditing, in terms of their behavior with respect to audit quality or sufficiency if they felt they had to deliver profits at a cost of getting all of the work done, potentially.

So, is there a distinction that maybe I'm still missing?

MR. KOLINS: Yeah. It wasn't so much the position that the person has, but the responsibilities that the person has. So, you know, that same person could have management responsibilities and supervisory responsibilities and some of the -- what that person perceives as management responsibilities can have an indirect association to the quality of the audit when it comes to hiring personnel, for example, with a background that Barbara had mentioned.

MS. RIVSHIN: Doug Anderson?

MR. ANDERSON: Yeah, I just had a quick comment. I'm kind of torn on this one, because in general I don't like overly prescriptive standards or rules, and in that sense, if it comes to the question of having a specific -- it was either detailed standard or general standard, I'd lean towards a general standard so you don't end up with a checklist standard which doesn't require auditors to use good judgment.

But I wanted to follow-up on something Steve had mentioned, and as I got thinking about this and during the discussion here, this is a pretty broad topic, as the failure to supervise. And if one of the motivations behind this effort is because the results of the inspection process, I'd encourage the PCAOB to find a way to get something like the report that we talked about yesterday on what we saw in the inspections on the audit firms, dealing with the economic crisis. If this is a big enough issue, it's driving potential rulemaking, if we could get more clarity on the specific kinds of things that we're seeing in the inspections, what part of that broad spectrum of failure to supervise are you seeing? That might help, not only guide the rulemaking process, but guide all of the firms to know where they should be worrying about, or concerned about the weakness areas that are in other firms that may be affecting their firm.

MS. RIVSHIN: Thank you, Doug.

One of the things the concept release also seeks comment on are the potential unintended consequences if a Board were to go down a path of potential rulemaking in this area, and that's broad to either the general or the specific approach. Wanted to pose this question to the SAG in case you had any thoughts about any potential unintended consequences?

Barbara Roper?

MS. ROPER: The only thing I'd say, briefly, is -- and the reason I think it's important to, as I say, to follow the chain of responsibility up the ladder is that if you're within a firm -- this is common in the broker-dealer world which is the primary area where I dealt, as I said, in the large firm report, more than 80 percent of the violations were in one company. So, if you're in a company that compensates and promotes and does evaluations and everything, to encourage an approach that's not in the investor interest. The fact that there's a person named on a chart as being responsible for one particular area shouldn't leave them holding the bag for what's created -- a culture that's created within the corporation.

And so, I think -- I don't see this as a downside to having failure to supervise responsibility, I think it's a caution to make sure that in developing that, it goes all the way to the -- up the ladder.

MS. RIVSHIN: Thank you, Barbara.

Bill Gradison?

MR. GRADISON: Just for the record, the largest monetary sanction that has ever been imposed by this Board, so far, was in connection with a failure to supervise. It was a million dollars, it was levied against one of the biggest firms.

I only mention that because some of the discussion a little while ago might have given the impression that nothing is going on in the enforcement area with regard to failure to supervise. At least there was that one back in December of 2008. And that does lead me to a question, in view of that enforcement action -- which is public information -- what would a rule add that -- beyond the precedent already set by that sanction?

MR. STEVESON: The -- I think the Board's release tries to make clear that the rule is not necessarily necessary to impose sanctions for failure to supervise. And I think in the case you're referring to, it wasn't even under 105(c)(6), but related to specific failures to do things required -- cited in the standards.

So, there's no obstacle -- you're absolutely right -- there's no obstacle to the Board bringing more enforcement actions like that.

The point of the type of rule we're talking about today would be to -- to see whether there are ways that a rule could supplement that authority --

could be helpful both to the Board in identifying where responsibility lies for failure, and also by increasing accountability through the same mechanism to actually increase the quality of supervision, and increase the quality of audits.

MS. RIVSHIN: Doug Anderson?

[No response.]

MS. RIVSHIN: Well, then, Lynn Turner?

MR. TURNER: Bill, on that particular case, that case, that fine -- and I'm sure the firm considered it serious, but that fine was half of half of one percent of that firm's revenue, so I don't know that I'd consider that something that is really going to shake people up and take notice. It's almost like a cost of operation. I think if you want to get serious about what is -- if you see a case and if you thought it was all that serious, a fine in that magnitude may not get it done. The law specifically says you could have fined up to $15 million and you chose, instead, to fine less than 10 percent of what you are allowed to under the law, to fine.

And so, there's another message that could be sent by that, as well, and that is you didn't think it was that significant or that serious, or you would have used a much higher fine. So, I do think coming back and sending a stronger message in the enforcement cases would be helpful.

I personally think that, to your point, that would do better than a rule, but, you know, my God, if you need to go back and tell people one more time, they really need to do their jobs as partners and get it done, there's nothing like a good old fashioned $15 million enforcement case, and fine that audit partner up to the full max you can, of $750,000 per occurrence. You take a whack at a partner's personal pocketbook? And personally in these cases, I think in most of these cases we're going to find, had nothing to do with the national offices, had nothing to do with the CEO at the top, it was essentially down to the individual partner, where they didn't perform in accordance with the firm's standards. That's been my experience -- it hasn't been a firm-wide failure to supervise, it's been on down with that individual partner. And there's nothing like taking those out, and if you found one that failed to supervise on, say, three situations, go fine them $2 million bucks. That'll do more good than any rule you could ever write, but you've got to get serious about the fine, you know, half of half of one percent, and less than 10 percent of what you could have fined the firm? That doesn't send a strong message.

MS. RIVSHIN: Thank you, Lynn.

Barbara Roper?

MS. ROPER: Yeah, I mean, I think it's important to remember that the rule that you're talking about, here, is not to restate the obligation to supervise, the rule that you're talking about is to fully and carefully document where the obligation to supervise resides in different areas, and what that adds beyond enforcement is clarity, you know, we eliminate any ambiguity about where the -- and it gives you something to inspect against.

Because, you know, strong as we are in supporting enforcement, we like to avoid the situations where we need enforcement as the response. And you have a great mechanism, through the inspection and required remediation to correct problems before they blow up into something where we'd want an enforcement action as a result.

And so, I think something that provides clarity in terms of documenting throughout, you know, the various different possible complex areas where the line of responsibility lies, gives the Board something to inspect against that has the potential to strengthen those supervisory practices within the firms, particularly in the areas where they're not as clearly defined as they may be within the context of a particular audit.

And then, I would add, you know, about this notion that it's generally the audit partner, you know, I'm not sure the Arthur Anderson case actually supports that -- that notion.

You know, my memory is getting a little hazy. But as I recall, on the Enron audit there was a meeting with the risk committee within the firm in which the partners came in and identified -- carefully walked through all of the risks associated with audit and all of the concerns about the accounting that they were presenting and -- you know, and then everybody got

-- found a way to get comfortable with that situation. Well, in that case, it's not just the partner who's doing the audit, although obviously they have a clear responsibility, but it's the other people in the firm who enabled that conduct.

And so, I do think that taking those supervision obligations beyond the sort of narrow construct of the audit -- in which I think they're fairly clearly understood -- into this broader issue of the management and operation of the firm, is important.

MS. RIVSHIN: Jim Cox?

MR. COX: I wonder if a by-product of identifying, being specific where the duty resides would also come up in the context of minimizing the opportunities for being second-guessed by the SEC and its evaluation about whether the enforcement action is appropriate or not. So, I just wonder if that clarity on that front wouldn't be helpful, as well.

MS. RIVSHIN: Lynn Turner?

MR. TURNER: Yeah, I don't want to oppose rules, I think some guidance here is helpful, including at the type -- Barb is right about Enron. Xerox had top people right up to the CEO of the firm involved in that situation. Again, people at the senior level at Parmalat, including in the General Counsel's Office were involved in those decisions; the court documents all clearly show that and establish that. So, having the guidance that Barb talked about, about who's responsible so you've got something to inspect against, and hold people accountable, that is clear, I think is fine. But then, unless you hold them accountable for what you write, it won't matter.

So, go get yourself some good general guidance that you inspect and hold them accountable against, if you don't think what is out there now is adequate, and that's what's showing. But then you've also got to come through with some serious enforcement or the rule means nothing.

MS. RIVSHIN: Dan?

MR. GOELZER: Maybe just a clarification, and Michael, if you think I'm off track here, tell me. And Bill raised the case where we have an action against the firm, and then in that case there's also an action against the engagement partner on the particular engagement. The theory against the firm is that they hadn't complied with the QC obligations to staff that engagement properly because of problems they were aware of with respect to the partner.

And I think in that kind of case people might ask, "Well, aren't there other individuals at the firm beyond the engagement partner who had some responsibility to make sure that those QC requirements were operating?" But -- well, speaking of that case, particularly, it's difficult, often, to identify who those people are in a way that is really -- can serve as a basis for an enforcement action. So, that's the reason for this concept release. To ask, should we make the firms define for us, in advance, who has these responsibilities, so that if something, you know, falls apart, something goes wrong, we can identify the people who were responsible above the engagement level for the fact that the particular QC requirements didn't operate or weren't enforced, or whatever.

I'm just kind of responding to your point, Lynn. You can argue about the size of the fine and maybe the case should have been done differently, but what this proposal aims at is, well, are there other people in the firm hierarchy that should also be held responsible, and how do we identify those people?

MR. TURNER: And, if you lay that out, I think that's fine, Dan. I'm a little bit surprised that people are coming back to you -- and maybe the firms around the table could respond to this -- but I'm surprised that they would come back to you and say, "We don't know who's responsible for supervising that partner, and the quality on that audit." Obviously, you've got a concurring partner on each audit that's involved, and then you've got -- whenever I've seen it, there's been a very clear delineation of who the partners report up to and they may report up to a couple of people, depending upon the situation. But, I think if people are saying, "We don't know who is supervising in the firm," we've got a huge problem. You know, if a firm's giving you that answer, you've got a much bigger problem, and a million bucks doesn't touch that problem. I mean, but that's what I'm hearing you saying, you're saying that in these audits, people at the firm are coming back and telling you, "We can't tell who's responsible for overseeing the audit partner and the quality on a particular audit," and I find that very disconcerting. And I'd like to hear the response of the other four -- six firms around the table as to whether or not they really think in their firms they can't tell you who's responsible for overseeing the audit partner and supervising to make sure there's quality on an audit.

MS. RIVSHIN: Sam Ranzilla?

MR. RANZILLA: I was just thinking about putting it up, but I guess I do now.

[Laughter.]

MR. RANZILLA: Thanks, Bella.

MS. RIVSHIN: You have to actually thank John White, who complained yesterday that he didn't get a chance to make a comment because I wasn't fast enough.

MR. RANZILLA: Two of my favorite people.

Lynn, I'm not sure what you mean by supervise the audit partner. I think that there are certain aspects of engagement overall -- so if we're going to take this from engagement quality now, and -- individual engagement quality and map that up against the QC standards, I would say there are a number of different people that touch certain aspects of that engagement to ensure -- to provide reasonable assurance that the team, overall, complies with the standards. And I'm not trying to be cute, but there's a particular individual, or individuals, that might say, this is the right person for engagement X, because they've got the right skill set, they've -- whatever criteria you go through. There might be other people in conjunction with that that also says, client X is the right -- is a client that we're willing to accept or continue to perform as their auditors. There might be another individual that is responsible for the first line of consultation with respect to a technical issue, so you get the client in the door, you get the right people on it, and then you've got a question and you say, "Okay, how is the QC system designed so that if there are consultations it gets to the right place," and each firm has a different structure, whether it's regional, local, national -- but you need that, right? So, the engagement partner says, "I know where to go for a particular issue."

So, I -- is there one person -- I don't think there is just one person lined up in our firm to deal with each engagement partner. I think there's steps in the quality control system that are designed to have oversight at probably multiple levels. But, I don't know if that helps or not.

MR. TURNER: No, it does, Sam. But, I think back to the question that Bill raised, which was a very valid and good question, I think what you just said absolutely and very strongly makes the case for Marty and his staff to move forward with rulemaking because I think that notion of that broad a level of supervision does need to be defined and encompassed in what the rules define as supervision, as Dan just said. Because I don't think, when I read through the current quality control rules, they're even close to being that broad, or really address very adequately that situation. So, I think, given what you just said, I think it makes an extremely strong case for the Board to move ahead with rulemaking, and define it; and define it in that broad a context. It's not a narrow context whatsoever, then.

MS. RIVSHIN: Mike Gallagher?

MR. GALLAGHER: Yeah, just picking up on what Sam said, you know, it really is fact-dependent, right? If you have a bust, you know. Some cases, it's the audit partner didn't perform, and every piece of the system may have functioned perfectly, but that audit partner didn't perform.

So, maybe getting back to unintended consequences that, you know, while you certainly should pry apart what happened, and if the implications, you know, go beyond the audit partner, you know, to some of the things that Sam talked about, you know, did you have a partner that was overloaded? Or you had a partner that didn't have the right experience? Well, how did that partner find him or herself on that engagement? Right? How did they come to be -- did they get the right support from a concurring partner? I think those are reasonable questions asked. But sometimes it just falls to the partner and a lack of performance.

So, you know, the only caution I would have in this whole thing -- because I'm not troubled, quite frankly, about the standard, I think you probably have the authority under what exists today, but if you went at it, I think that's fine. I would also opt for the more general, rather than the specific, because I think it will be more scalable. But, you know, my only caution is not every single failure goes beyond the audit partner. And so, this hopefully won't be an effort to, "Let's see how many scalps we can get at the firms every time something goes wrong."

MR. BAUMANN: Michael, I think -- I'm going to have the same caution Dan had, stop me if I'm wrong. But, I don't think we're saying that it would necessarily go above the partner when something went wrong, if people above the partner did not fail to supervise reasonably. So, you go beyond them if they fail to supervise reasonably, if they knew that there was a defect in the partner's skill set, for instance, as opposed to the situation where he or she was perfectly suited for the engagement but, quite frankly, to nobody's knowledge, he just didn't do what was expected of him or her. Is that fair? Thanks.

MS. RIVSHIN: San Ranzilla?

MR. RANZILLA: Again, I was trying to answer

Lynn's question, but to my own view, I think we're supportive of your -- well, we are. I am. I am supportive of the objective that you're trying to achieve. I'm also -- would support a more general approach as opposed to the detailed approach.

The only question I have is, it seems to me that this ought to be baked in to what you're doing on the QC element, it should be a part of that rulemaking and not necessarily separate rulemaking, although I guess I -- maybe I don't appreciate -- but there might be some piece of it that gets into rules versus the QC standards and it may be different elements of the rules, but it would seem to me that it all ought to be done in conjunction with your current project on QC. They're certainly related.

MS. RIVSHIN: Arch?

MR. ARCHAMBAULT: Some of the discussion raised a question in my mind, in terms of, you know, what do you mean by supervisory person? Because, is somebody that is involved with responding to a consultation, as Sam was -- is that considered to be a supervisor of the engagement partner? And I think you may go back to something that Wayne was referring to, because there are a lot of people that touch engagements. From the time they start coming in the door until reports go out, and which of those individuals are viewed as supervisory personnel? It's not like the partner, I mean, you have a big difference at the partner's level, versus a partner supervising the work of the staff, because there's such a broad range of issues that can come up. So, that might be something to take a look at in terms of clarity and definitions.

MS. RIVSHIN: Arch, we'll consider that.

Gaylen Hansen?

MR. HANSEN: Yeah, I'd like to basically agree with Sam. And I think that this does need to be baked into the QC standards, but if you recall, in going back to our conversation yesterday, if that's the case, then there needs to be some minimum standards within the QC guidelines, not just, you know, broad guidance, "You should do this, you should do that," but not a -- really a requirement to do anything. There has to be some minimum QC standards.

And then as to Arch's comments a minute ago, what do you mean by "supervising" and a lot of people touch these engagements -- I absolutely believe that -- there's instances where maybe it's not a technical auditing or accounting matter, but it can even be independence -- who has signed off on independence if it's a complex technical issue? And these firms, I mean, internally, they know who's responsible within the organization. And there are those lines of authority and so forth, those have to be documented, somehow, in the QC document, as to what -- you know, who says this is okay? And if that's addressed in the QC document, it shouldn't be all that tough to identify who is responsible.

But, the problem with all of this, I think, is getting back to the unintended consequences because if -- what you could do is really set yourself up for somebody trying to obfuscate or blur those lines of authority, so that it is not clear.

MS. RIVSHIN: Thank you very much, Gaylen.

And, thank you everyone on the SAG for your very thoughtful comments. I have to say that -- Steve

Harris, would you like to make a statement?

MR. HARRIS: We've heard from both Steve and Doug in terms of what we're actually finding, but I think we probably should take that under advisement, and figure out, you know, how to get back to you. I mentioned in my statement that this comes up in virtually -- a significant volume of the Inspection reports that I've read. And therefore, from my perspective whether it's a remediation issue, an enforcement issue, it's clearly a clarity issue. Because the message has not been received by the firms. Or, for that matter, potentially by our inspection staff. But they are finding problems in this area which go beyond a simple enforcement.

So, I think it is incumbent upon us to consider the approaches that you've outlined. I think there may be a consensus -- although I may be overreaching, but there ought to be a general approach as opposed to a specific, detailed approach. But then I think we may have a responsibility to get back to Steve, the issue that you raised, so that you know exactly, you know, in more detail, with certain parameters, what we're finding.

But, as I say, I think this is an extremely important initiative because of the sheer volume of Inspection reports that mention this issues, and it's mentioned year after year after year without successful remediation.

So, there is a gap in terms of what we're finding, and the lack of action. So, I applaud your bringing this up today and, you know, I look forward to our moving it.

MS. RIVSHIN: Thank you, Steve.

Steve Rafferty, did you have -- ?

MR. RAFFERTY: Yeah, I would like to say, first of all, I agree it's a very important topic that should be discussed and dealt with, but I -- I still question whether it is a policy or rule issue, or an execution issue. And I think there may be times when inspection -- if you are truly going out to do inspections, and people are saying, "I didn't know this was my responsibility," you may well want to challenge the validity of that assertion. Because I do find it very difficult -- and just from my own experience in our firm and in peer reviews -- to believe that in most cases engagement teams particularly don't know precisely what their responsibilities are, which makes me question whether it's an execution versus a clarity issue.

The other thing would be that, if it is a clarity issue and it's that widespread, I agree maybe rulemaking is the way to go. But in your document, here, that you wrote, you said it would facilitate the Board's assessment through the inspection process of a firm's supervisory practices. It would seem to me that if you truly can't, in the inspection process, determine what those practices are, and the firm can't articulate that, then that would, in fact, be an inspection finding that would require remediation, and you could resolve a lot of these issues that way.

But, again, if it were truly widespread, then maybe rulemaking would be necessary.

MS. RIVSHIN: Thank you, Steve.

Steve Harris, did you have any other thoughts? No?

Well, thank you very much for all of your thoughtful commentary, we'll take that under advisement, and I also wanted to point out that if there's any additional thoughts that people around the table have, or those listening to the webcast, the comment period is still open until November 3rd, and we encourage you to submit a comment letter. Because we really want to figure out what the best approach is, and for the staff to analyze the comments we received today, the ones that will come in by November 3rd, and present a balanced view to the Board for their consideration.

And now I'll turn it over to Marty for the next discussion topic.

MR. BAUMANN: Thanks, Michael, and thanks Bella. And I echo Bella's thoughts -- thanks, everybody, for your thoughts on that subject.